A Response

to the Minister's Discussion Paper

on

Public Sector Pensions

Special Forces Pension Plan

Alberta

Special Forces Pension Plan Board

September 30, 1991

Alberta
GOVERNMENT PENSION BOARDS

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September 30, 1991

The Honourable Dick Johnston
Provincial Treasurer &
Minister Responsible for
Public Sector Pensions
224 Legislature Building
EDMONTON, Alberta
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Sir:

Subject: Response to the Proposed Plan Changes

On behalf of the Special Forces Pension Plan Board, I have the honour to submit our initial response to your July 9, 1991 proposal "Planning Responsibly for the Future - A Discussion Paper on Public Sector Pensions" in respect of the Special Forces Pension Plan.

Yours truly,

J. E. Faries, FCIS
Chairman

Encl.

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PREFACE

In July 9, 1991 the Honourable Dick Johnston, Provincial Treasurer and Minister responsible for Public Sector Pensions released a document entitled "Planning Responsibly for the Future - A Discussion Paper on Public Sector Pensions". This report was prepared at the Minister's request for a response to his proposed changes to the Special Forces Pension Plan (SFPP).

The SFPP Board is composed of employee, employer and government representatives and has a legislative responsibility to advise the Minister. The Minister, in presenting his proposal for reform, has highlighted a number of very critical concerns of employees, employers and beneficiaries under the government sponsored public sector pension plans. The Board, since 1985, has made a number of recommendations dealing with many issues and some of those recommendations have been reflected in the Minister's proposal. However, this is the first time that the Board has had an opportunity to respond to a formal proposal from the Minister. Although the Board is pleased with the opportunity to participate in the reform process, it is concerned about the compressed period for consultation and the focus of reform is not so much about securing the benefits of the plan but more about the government capping its liability. In addition, while the Board is pleased to provide its advice, it must be emphasized that the Board is not empowered to negotiate on behalf of employers or employees in the plan.

Given the time constraints that the Board has had to work under, this is an "initial" response. Simply understanding, communicating and responding to the proposal put forward by the Minister has excluded the consideration of alternatives. This report is an "initial" effort to start the necessary dialogue to achieve a solution that is acceptable to all parties to the "pension deal".

MEMBERS OF THE

SPECIAL FORCES PENSION PLAN BOARD

J. E. Faries
Chairman

A. F. Collins
Government Representative & Vice Chairman

Employee Representatives	Employer Representatives
M. P. Dungey Alberta Federation of Police Association	B. L. Ardiel Alberta Urban Municipalities Association
N. E. Koch Alberta Federation of Police Association	A. J. Habstritt Alberta Urban Municipalities Association

EXECUTIVE SUMMARY

In order to understand the government's proposal and fully appreciate its impact, it is important to recognize the unique history of the Special Forces Pension Plan (SFPP). The SFPP was the product of negotiations between employees and employers and then subsequently with the government to develop a uniform plan. This plan was to be funded on a cash flow basis, with the benefit secured through the sponsorship and guarantee of the province.

The Minister's proposal represents a dramatic departure from that original pension deal. The proposal calls for full funding of both past and future service. Employees and employers would be required to fund future service as it accrues. The Minister also proposes that employees and employers share with the government in liquidating the unfunded liability and this will effectively "cap" the government's liability to the plan and significantly shift the financial risk to the employees and employers. As a result, the plan will change from government sponsorship to a shared risk-reward arrangement.

It is the view of the Board that the past service unfunded liability is a result of the government's agreement to partially fund the plan. The funding of accrued obligations, however defined, remains the obligation of the government. This can lead to a clear distinction between the past and the future. At some point it may be appropriate to enter into a process of negotiation to integrate the funding of the two periods of service.

The Board acknowledges that some form of shared risk-reward arrangement is inevitable if a defined benefit plan meeting the needs of the current SFPP participants is to survive. Employees and employers recognize the need to secure the funding of the plan and have indicated that they are willing to meet the on-going current service cost in the future. However, the imposition of such an arrangement without addressing issues of governance is inappropriate. Therefore, for such an arrangement to have legitimacy, employees and employers must have a degree of participation commensurate with the risk they bear.

The response of the Board is summarized as follows:

1. The unfunded liability of the plan remains an obligation of the government and it is up to the government to fund it from the General Revenue Fund of the province. Any surcharge or "payroll tax" on the employees participating in the plan or their employers is rejected.

2. A negotiation process similar to what was used to develop the SFPP be established with the mandate to renew the "pension deal". The process would adhere to the principle of full funding for current and future service.

3. A formal joint board of trustees be established to provide governance on benefits accrued for service rendered after 1992.

4. Until such time that negotiations are complete and a board of trustees are in place, existing benefits and explicit/implicit promises made to the plan beneficiaries must not be changed except those amendments required to comply with Federal tax reform.

HISTORY OF THE PLAN

The SFPP was introduced in 1978 to provide a uniform plan for police and firefighters. Prior to 1978, individual cities and towns participated in the Local Authorities Pension Plan (LAPP) and provided supplementary retirement benefits to police and firefighters. Labour legislation dealing with police and firefighters provided those groups with the right to negotiate pension benefits. However, participation in the LAPP specifically excluded negotiation of pension benefit. As a result of binding arbitration awards, the police and firefighters were granted supplemental plans in addition to the benefits of the LAPP. This arrangement eventually proved to be unworkable and led to proposals for a uniform plan.

The Plan, in the end, only included police, as the firefighters prevailed upon the government to exempt them from the SFP Act. The key difference in benefits between the SFPP and other Alberta family plans is its early retirement and disability provisions. The funding of the plan was also unique in that a single contribution rate of 14% was set in statute with the respective employee and employer shares to be established through collective bargaining.

In reviewing the documentation concerning the initial funding of the plan, the following observations can be made:

1) It was recognized that full funding of current service would have required a contribution rate of 19.13% of payroll. However, because the proposed benefit was a combination of benefits under the LAPP and existing supplementary plans, the SFPP benefit was funded to the same extent as the LAPP while the supplementary benefit was intended to be fully funded. The supplementary benefit was estimated to be about 4.42% of payroll and the LAPP was considered only partially funded at 9.26% of payroll; therefore a 14% contribution rate was considered acceptable[1].

[1]Technical material related to the plan's original funding was drawn from the minutes and files of the Special Forces Pension Board.

2) Rate increases beyond the 14% were conditional on if and when the underlying LAPP rate was increased to fund future service. The LAPP rates were not increased until the beginning of 1985. However, the SFPP rates were not changed at that time in spite of the recommendation by this Board to do so.

3) It was understood that any liabilities for past service would be assumed by the government upon the transfer of the accumulated contributions and interest from the LAPP and an amount, as established by the government, from the supplementary pension plans operated by a number of Cities.

4) Future service was to be funded on a cash flow basis[2]. If the contribution rates would generate a positive cash flow over a pre-determined period into the future (i.e. 30 years) they would be considered to have met the current "cost" of the plan.

Initially, the plan could be considered to be "terminally funded". Employee and employer contributions were paid to the General Revenue Fund (GRF). All benefits were paid from the GRF and were therefore "funded" by the government when a member retired. The plan was considered "secured" because of the perpetual nature of government and the presence of the government guarantee of the benefit. It could be argued that this funding arrangement was considered desirable by all parties involved. Employees received and the employers provided a benefit for a fixed cost, without the necessity of pre-funding, while the government, in exchange for absorbing the financial risk of the plan, had at its disposal a captive pool of financing.

[2]This was the common funding discipline of the public sector plans in the 1970's.

While the deal itself was the product of tripartite negotiations, once implemented it became a government sponsored plan. The plan sponsor has been defined as "the organization or body which has the final authority to start a pension plan, make revisions to an existing plan or wind up a pension plan[3]." The SFPP was created by legislation, and the plan could not have come into existence or continued without the sponsorship of the government.

The government's sponsorship of the plan was also confirmed by the government's retention and consolidation of plan decision making with regards to key components of the pension deal, including:

1) **Plan administration.** The government has always controlled the appointment of plan administrators with the administration operating initially as a separate department of government and then subsequently as a division of Treasury. Initially, the administration was accountable to the SFP Board, that line of accountability was reduced in 1981 when the administration was transferred to Treasury and altogether eliminated in 1985 with the creation of the SFPP Board.

2) **Pension fund structure.** In 1981, the government created a "pension fund". This fund was considered to be a fiscal management device of government to offset the growing liability of the collective pension obligations guaranteed by the Province. The government made an "initial deposit"[4] of $1.1 billion. The decisions to make the deposit, how much it was, to create a single fund rather than account for each plan separately, and to manage the fund within a division of Treasury, were decisions made by the government and reflected the government's interests as sponsor of the plan.

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[3] Task Force on the Investment of Public Sector Pension Funds, In Whose Interest, Queen's Printer For Ontario, 1987, p. 329.

[4] Mr. L. Hyndman, Alberta Hansard - March 28, 1980; p.122.

3) **Funding policy**. The global employee and employer contribution rate was set in legislation. The relative split was then set through negotiation. The SFPP Board has on several occasions recommended that employee and employer contributions be increased but the government decided against it. The initial rate was set in 1978 on a cash flow basis. The government has changed the funding objective with the establishment of the pension fund in 1981 when the plan became "partially funded". In this proposal, the government has indicated that full self-funding is now appropriate.

4) **Investment policy**. Employees and employers have been excluded from participation in this decision. The government has maintained control of investment policy which, appropriately reflects the government's sponsorship of the plan and guarantee of the benefit.

5) **Benefits policy**. The formula benefit has been unchanged throughout the history of the plan. However, a significant benefit, indexing has remained a government's discretion. Previous actuarial valuations have included a 75% COLA to pensions in establishing the "total obligation of the Alberta government in respect of the Alberta government's guarantee of the benefits provided by the Plan."[5] Employee and employer representatives through the SFPP Board have made recommendations in the past regarding formally recognizing the benefit and the level of adjustments granted each year. There is little evidence, if any, that these recommendations have had any impact on the government's decision.

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[5]From the 1988 Actuarial Valuation for the Special Forces Pension Plan by the Wyatt Company.

From an historical perspective, a number of conclusions can be made.

1) The SFPP was created by a process of negotiation. The fact that the SFPP was ultimately legislated suggests that all the parties at that time were satisfied with the terms and conditions of the agreement.

2) By definition the government is the sponsor of the SFPP, which has been confirmed by the way the plan has been actually run. The government retained control of decision making, guarantee of the benefit and its discretion to provide periodic adjustments to pensions under payment.

3) A profound change to the plan has been in its funding policy. The funding discipline has been changed from terminal funding to partial funding and is proposed to be changed to full funding.

THE MINISTER'S PROPOSAL

The Minister's proposal has three expressed goals:

1) meet the new Federal Income Tax rules,

2) improve portability of future service benefits,

3) secure the financial base.

In order for the SFPP to remain registered and required employee contributions to continue to be tax deductible, compliance with the Federal Income Tax Act is necessary.

To improve portability of future benefits, the proposal recommends the introduction of a termination benefit consistent with the "50% rule"[6] found in the Alberta Employment Pension Plan Act (EPPA). This benefit would apply only to service earned after 1992. In addition, the reciprocal agreement (in this case with the Local Authorities Pension Plan) would be cancelled.

The goal to secure the financial base is by far the most important in that it deals with the funding objective of the plan, current service costs, indexing, and liquidating the unfunded liability. Before responding to the proposal it is important to understand the impact and significance of these changes.

To secure the financial base of the plan, the government's proposal notes that "true pension security for employees requires that all benefits be fully funded and backed by marketable assets." To achieve this goal the proposal goes on to recommend that:

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[6]The 50% rule is based on calculating the commuted value of a pension with the employer required to pay at least half of the commuted value; see EPPA, Section 29.

1) The indexing promise be formally recognized at 60% of inflation for both past and future service.

2) The cost of liquidating the past service unfunded liability of the five plans be equally shared by employees, employers and the government.

3) Future service as it accrues be paid by employers and employees by requiring that contribution rates be adjusted to reflect the "annual pension cost".[7]

These proposed changes will transform the plan from a partially funded, government sponsored defined benefit pension plan to a full self-funded employee/employer shared risk-reward arrangement.

This represents a fundamental change to the pension deal. No longer will the pension promise be secured by the government guarantee but by the ability of plan assets to generate a sufficient rate of return. Effectively two thirds of the funding risk associated with the past service unfunded liability and all of the funding risk associated with future service will be transferred from the government to employees and employers by imposing the discipline of self-funding.

These proposed changes have provoked a discussion of governance among employees and employers in terms of:

1) **Accountability/participation in decision making to manage their newly acquired risk.** In "fixing" the funding, the government has fundamentally altered the incidence of risk within the plan. For service accruing after 1992, adverse investment experience, aging in the underlying plan demographics or a change in plan assumptions will be immediately reflected in higher contribution rates. Experience losses (gains) attributable to service prior to 1992 will expand (contract) the effective amortization period and will be reflected in the total contributions made

[7] "Annual Pension Costs" means contributions required to fund current service benefits and any plan deficiencies over a specified period of time (eg. 15 years).

by employees and employers over the amortization period. Despite absorbing a significant portion of the risk, in the proposal there will be no significant change in the governance of the plan. However, if employees and employers are to adequately manage the risk that they must now absorb, they must be able to monitor, assess and effect decisions that impact on that risk.

2) **The cost effectiveness of benefit design to meet the needs of the participants.** Under a discipline of self-funding, the cost effectiveness of benefit design becomes more acute. The basic question of "Within the context of a specific industry, the tax environment and total compensation, are we getting good value for our money?" will be asked many times. In terms of this proposal, there are a number of benefit changes (such as the cost and adequacy of the proposed indexing formula) that employees and employers may want to re-assess within the context of a shared risk-reward arrangement.

The government wants employers and employees to share that fiscal responsibility. There are indications that they are prepared to accept this new pension deal provided they can gain authority in how the plan is run. Simply fixing the funding arrangement of the pension deal without articulating and accepting the governance context of a shared risk-reward plan will leave the pension deal without the legitimacy necessary to impose the discipline of self-funding on its members.

THE BOARD'S RESPONSE

The Board is on record as recommending that contribution rates reflect the cost of the plan and therefore accepts the principle of self-funding. The acceptance of this discipline is more a recognition of reality than an explicitly held view that it is better than any other arrangement. If the government no longer wants to accept financial responsibility for the plan then some other arrangement must be put in place. **The Board recommends that:**

1. **Employees and employers should fully fund current and future service conditional on a discussion of plan governance.**

While the need for full funding is recognized, simply accumulating assets to match the accrued liability of the plan is necessary but not sufficient to fully secure the benefit. Full funding requires a governance as well as a financial context. Simply fixing the funding arrangement of the pension deal without the parties articulating and accepting a shared risk-reward form of governance would leave the pension deal without the legitimacy necessary to impose the discipline of self-funding on its membership. In other words, the pension deal and its funding must be re-negotiated and put in the appropriate governance context. For both employees and employers to have a meaningful role in the governance of the plan, **the Board recommends that:**

2. **Governance should be in the form of a joint board of trustees with representation from employees, employers and possibly the government.**

3. **The administration of the plan should be removed from departmental control and set up as a separate agency.**

If a new pension deal is to be negotiated then careful consideration must be given to what is to be re-negotiated and by whom. There has to be a clear distinction between the past and the future. An explicit deal was made and agreed to by all parties in 1978. That deal was sponsored and guaranteed by the government. The value of the pension service that has accrued to date is legally vested in the participants of the plans. At this time, it remains the obligation of the government. **The Board recommends that:**

4. **The obligation to fund the past service unfunded liability rests with the provincial government as sponsor and guarantor of the plan for service accruing up to 1992 and it is up to the government to fund it from the General Revenue Fund.**

In terms of future service, it is possible to re-negotiate the existing deal. It is the view of this Board that precedent be followed and the parties be allowed to go through the same process used in 1978 when the first deal was concluded, only this time within the context of self-funding. This would seem to be the logical way to deal with benefit design, indexing and current service costs. Therefore, **the Board recommends that:**

5. **A process be put in place to allow employees and employers to negotiate a new "pension deal".**

The funding of pre-1992 service as it is currently defined, remains the obligation of the government. It is recognized that benefits payable on service earned after 1992 may be different than service accrued up to 1991 as a consequence of Federal tax reform and a negotiated new pension deal. This would result either implicitly or explicitly in two plans. To maintain a uniform benefit, negotiations may be necessary to reconcile the two periods of service. **The Board recommends that:**

6. **The new board of trustees be empowered on the mutual consent of the parties to negotiate a reconciliation, if necessary, between the post and pre-1992 service.**

It is recognized that compliance with Federal tax rules will require some amendments to the plan. However, given the scope of the discussions needed to renew the pension deal, those changes should be restricted to what is required to achieve minimum compliance. **The Board recommends that:**

7. **Apart from compliance with Federal income tax rules, no changes to benefits or plan design should be implemented until negotiations have been completed and the board of trustees is in place.**